WILLOUGHBY & HOEFER, P.A.

ATTORNEYS & COUNSELORS AT LAW

1022 CALHOUN STREET (SUITE 302)

P.O. BOX 8416

COLUMBIA, SOUTH CAROLINA 29202-8416

MITCHELL M. WILLOUGHBY
JOHN M.S. HOEFER
ELIZABETH ZECK*
PAIGE J. GOSSETT
RANDOLPH R. LOWELL
K. CHAD BURGESS
NOAH M. HICKS II**

*ALSO ADMITTED IN TX
**ALSO ADMITTED IN VA

AREA CODE 803
TELEPHONE 252-3300
TELECOPIER 256-8062

June 2, 2005

VIA EMAIL AND U.S. MAIL

The Honorable Charles L.A. Terreni
Chief Clerk/Administrator
Public Service Commission of South Carolina
Post Office Drawer 11649
Columbia, South Carolina 29211

RE: Application of Carolina Water Service, Inc.;
Docket No. 2004-357-WS

Dear Mr. Terreni:

The purpose of this letter is to provide to the Commission the comments[1] of the Applicant, Carolina Water Service, Inc. ("CWS" or "Company") on the proposed order ("Proposed Order") of the South Carolina Office of Regulatory Staff ("ORS") filed on May 31, 2005 in the above-referenced proceeding. These comments are necessary because of the highly irregular and unlawful process that ORS seeks to employ in proposing a decision to the Commission in this docket. I respectfully request that this letter be placed in the docket file and circulated to all Commissioners prior to any vote taken by them in the above-referenced docket.

After months of pre-hearing audits, discovery and hearings in this docket, ORS now attempts in its Proposed Order to impeach the testimony of its own expert witness, Ben Johnson, PhD., to

[1]CWS makes these comments for the purpose of pointing out to the Commission factual and legal issues presented in the ORS Proposed Order not raised to the Commission below, the inclusion of which in an order would prejudice CWS's rights if left unchallenged. CWS is surprised and dismayed at this effort by ORS to procure a decision in this matter by suggesting that the Commission employ an unlawful– indeed an unconstitutional– procedure. CWS reserves its right to raise any and all issues it deems proper in a petition for reconsideration if one becomes necessary and to seek judicial review on any available ground – including, but not limited to, a hearing in circuit court on irregularities in procedure if the ORS proposal is adopted. See S.C. Code Ann. §1-23-380(5)(2005).

(Continued . . . .)

reduce the allowable return on equity (ROE) below the low end sponsored by ORS at hearing – i.e., 9.5%. In order to justify a return below that level, ORS proposes that the Commission issue an order (a) disallowing an upward adjustment of .4% for flotation costs proposed by Dr. Johnson in his DCF analysis and (b) disallowing an upward adjustment of .6% proposed by Dr. Johnson in his DCF analysis to account for the relatively higher risk faced by CWS due to its size in comparison to the ten (10) proxy companies utilized by Dr. Johnson. As a result, ORS proposes that the Commission adopt an ROE of 8.5%. See ORS Proposed Order at pages 10 and 11, ¶¶ 9 and 10. The ORS proposed findings regarding ROE are troubling and problematic on a number of levels.

First, although a party may impeach the testimony of its own witness under our Rule 607 of the South Carolina Rules of Evidence (SCRE), it cannot do so by urging a finding inconsistent with the testimony of its own witness **after the examination of the witness has been completed.** *Cf. Hagood v. Sommerville*, 362 S.C. 191, 199, 607 S.E.2d 707, 711 (2005) (observing that impeachment of direct testimony by adverse party is to be accomplished by cross-examination, citing Rules 607-609); *Okatie River LLC v. Southeastern Site Prep, LLC*, 353 S.C. 327, 337-338, 577 S.E.2d 468, 473-474 (Ct. App. 2003) (observing that the note to Rule 607 SCRE "edifies in regard to a change **in courtroom practice.**") Were it otherwise, a party could be subjected to a veritable "parade of horribles", including the following: the credibility of a witness being challenged without the opportunity for opposing parties to cross-examine on that point (*cf.* Rule 611(B), SCRE); depriving a party of the opportunity to introduce evidence to corroborate the testimony sought to be impeached (*see Jolly v. State*, 314 S.C. 17, 443 S.E.2d 566 (1994); and, *de facto* revisions by a party in the hearing testimony of its witness post-hearing to affect an outcome in a proceeding without notice to other parties or an opportunity to be heard (*cf., inter alia*, S.C. Const. art.I, §22). CWS submits that permitting a party to wait to impeach the testimony of its own witness until after the examination of the witness has been completed and the hearing closed [Tr.p.520, ll.10-11] unconstitutionally denies the other parties due process of law and would therefore constitute reversible error. See S.C. Code Ann. §1-23-380(A)(6)(a) and (c)(2005).

Second, ¶ 9 of the ORS proposed order implicitly assumes that its own witness had no basis for including a flotation cost adjustment in his estimate of ROE. In addition to being rank speculation, this proposed finding is contradicted by the evidence of record. The ORS witness had clearly reviewed the direct pre-filed testimony of the Company's expert witness, Pauline Ahern, at the time he prepared his direct pre-filed testimony [see, e.g., Tr. p. 253, ll. 18-19] and had heard the testimony of CWS witness Ahern under examination by the Commission. [Tr.p.217, l.15 – p. 218, l.2.] Thus, it was within both ORS's and Dr. Johnson's knowledge at the time he offered his opinion (a) that CWS issues no securities of its own, (b) that Mrs. Ahern did not include an adjustment for flotation costs in her DCF analysis and (c) that Dr. Johnson had included such an

(Continued . . . .)

adjustment.[2] When utilizing the DCF approach to estimating cost of equity, the underlying theory is based upon investors' future expectations regarding **market** performance – a point specifically acknowledged by ORS' own witness. [Tr. p. 265, l. 19 – p. 266, l. 3.] Thus, an "[e]stimate of the cost of equity derived from the Discounted Cash Flow . . . approach[] [is a] **market** value estimate. Since commissions generally regulate on a book value basis, an argument is often made that the market value estimate cost of the cost of equity should be adjusted to a book value basis." James C. Bonbright, Albert L. Danielsen, and David R. Kamerschen, *Principles of Public Utility Rates* (1988) at 332 (emphasis supplied). "Accordingly, it is argued that if the allowed return on book equity is set equal to the market cost of equity, a new stock issue would have the effect of diluting the equity per share of current shareholders. To protect against this dilution of capital, **theoretically**, the return on book equity should be set somewhat above the **market** value cost of equity." Id. (emphasis supplied). Therefore, the inclusion of an adjustment for flotation costs in arriving at a cost of equity using the DCF analysis is a theoretical undertaking based upon expected market performance and is not dependent upon whether there is in fact a planned stock issue by the utility whose ROE is being estimated. Accordingly, in the instant case Dr. Johnson applied the DCF analysis not to CWS but to a group of ten (10) proxy companies, for the precise reason that CWS does not issue stock and its parent is not publicly traded. [Tr. p. 244, ll. 8-11.] CWS submits that the application of this theory of equity cost estimation recognizes that flotation costs are embedded in each dollar of equity raised. Timing of stock issuance is therefore irrelevant since the return is being estimated based upon comparable companies of comparable risk as required by the *Hope* and *Bluefield* cases. Thus, it was entirely appropriate for Dr. Johnson to have included an adjustment for flotation costs experienced in the market based upon an analysis of ten publicly traded companies.[3] ORS had every opportunity to explore Dr. Johnson's reasoning in arriving at his

[2] Notwithstanding this, Dr. Johnson consciously determined and testified that an adjustment for flotation costs was appropriate for purposes of his DCF analysis [Tr. p. 253, ll. 11-14] and ORS knowingly permitted him to so testify to the Commission. If for no other reason, ORS should not be permitted to now vary from the testimony of its own witness on the grounds of waiver given that ORS elicited testimony from Dr. Johnson that flotation costs should be permitted. *Cf. Gary v. Jordan*, 236 S.C. 144, 113 S.E.2d 730 (1960)) holding that a party's re-direct examination of its witness on subject matter of cross-examination objected to by that party without reservation of objection waives any objection); *also compare* Rule 103(a), SCRE.

[3] In addition to the foregoing grounds, the fact that Mrs. Ahern was unaware of any plan on the part of CWS to issue stock in the near term [Tr. p. 217, l. 22- p. 218, l. 2] does not mean that an adjustment for flotation costs is inappropriate in the context of DCF analyses. To the contrary, some regulatory bodies do not require an imminent stock issue before an adjustment for flotation costs is permitted. *The Regulation of Public Utilities, supra,* at 393-4, n. 99. Moreover, the Proposed Order contains a mischaracterization of the holding of the Supreme Court in *Hamm v. S.C. Public Service*

(Continued . . . .)

estimated cost of equity employing a DCF analysis to include a flotation cost adjustment, but did not do so. The Commission should not countenance an effort on ORS's part to now parse the testimony of its own witness, using an implicit assumption for which there is no evidentiary basis and which no party had an opportunity to explore through cross-examination, in an obvious attempt to reduce the allowable range of returns on equity to a point below that testified to by any witness in the case.

Third, ORS's proposed finding by which the Commission would reject the .6% upward adjustment to the estimated range of ROE to which ORS's own witness opined suffers from analytical and evidentiary flaws. For example, ORS suggests by its Proposed Order that Dr. Johnson advocated this adjustment based upon the size of CWS's customer base and revenue stream relative to other water and sewer utilities operating in South Carolina. [ORS Proposed Order at 11, ¶ 10.] ("Based upon annual reports filed with the Commission, CWS has the largest number of customers of any privately owned water or sewer utility operating in South Carolina, and CWS has the highest amount of revenue of any privately owned water and sewer company in the state based on its annual report.") Yet, a cursory review of the testimony of its own witness would have revealed to ORS that the basis for Dr. Johnson's adjustment was a **comparison** of the size of CWS's service territory in South Carolina, relative **to the proxy companies** selected by Dr. Johnson for his DCF analysis, that translates into higher risk due to lack of geographic and economic diversity. [Tr. p. 253, ll. 14-17.] There simply is no evidence of record supporting the comparison proposed by ORS in this regard. Further, an analysis of CWS's business risk compared to other utilities in South Carolina – in addition to being totally inconsistent with the proxy group utilized by the ORS witness in arriving at his DCF-based estimate of ROE – is legally inappropriate absent admissible evidence of record demonstrating the basis for such a comparison. *Cf. Heater of Seabrook, Inc. v. Public Serv. Comm'n*, 332 S.C. 20, 26, 503 S.E.2d 739, 742 (1998) (holding that the Commission may not determine method for setting utility rates by comparison to method used to determine rates for another utility absent evidence of record regarding the comparison utility.) Finally, ORS's proposal that the Commission take notice of certain CWS annual reports and other filings [Proposed Order at 11, n.3] is improper. Under 26 S.C. Code Ann. Regs. R. 103-870.C (1976), a request that the Commission take notice of cognizable facts must be presented to adverse parties prior to or at

---

Comm'n, 309 S.C. 282, 422 S.E.2d 110 (1992). ORS states that "the Supreme Court reversed a decision by the Commission where the Commission set a rate of return on common equity including financing costs and "market breaks" adjustment, which are both adjustments tied to projected new stock issues, and where there was no evidence in the record of an intention to issue common stock in the near future." A casual reading of this case reflects that it was the Commission, and not the Court, that rejected these adjustments. ("Since there was no evidence that SCE&G intended to issue common equity stock in the near future, the Commission found these adjustments were unwarranted.") *Id.*, 422 S.E.2d at 113. The issue of inclusion of flotation costs was not, therefore, presented to, considered by, or ruled upon by the Court in *Hamm*.

(Continued . . . .)

hearing and that the adverse party be afforded an opportunity to contest the material proposed to admitted as a cognizable fact. That has not been done in the instant case and, therefore, the Commission may not adopt this portion of the ORS Proposed Order. *See In Re: Annual Review of the Purchased Gas Adjustments (PGA) and Gas Purchasing Policies of South Carolina Pipeline Corporation*, Docket No. 2003-6-G, Order No. 2003-489, August 8, 2003, at 8-10.[4]

Fourth, should the Commission be disposed to accept the proposed findings and conclusions set forth in ¶¶ 9 and 10 of the ORS Proposed Order, it should consider rejecting the entirety of Dr. Johnson's opinion regarding ROE based upon the DCF approach. This is so because, as Dr. Johnson himself recognized, the credibility of an expert witness and the reliability of his analysis – and not the specific methodology to estimate ROE – are of paramount importance to the Commission. [Tr. p. 266, ll. 4-16.] It is abundantly clear that ORS now does not consider the testimony of its own expert witness to be credible or his analysis to be reliable on two specific points he relied upon to develop his range of ROE's using the DCF approach that he recommended to this Commission. That being the case, there would be a lack of evidentiary support for his opinion regarding a range of ROEs based upon DCF. Conversely, Dr. Johnson has rendered an independent opinion of a range of ROEs applying the Comparable Earnings Analysis, or Comparable Earnings Method (CEM), approach. Dr. Johnson's CEM analysis relies upon different data sources than [Tr. p. 231, ll. 7-10], and is independent of [Tr. p. 244, l. 4] his DCF analysis and does not suffer from the putative credibility and reliability gaps identified by ORS.

In conclusion, CWS submits that ¶¶ 9 and 10 of the ORS Proposed Order not only suffer from the factual, legal, procedural and evidentiary infirmities described above but, if not rejected, will unfairly place the Commission in a position where it could be perceived to have ignored the position taken by ORS in this case and to have made an upward adjustment to the ROE recommended by ORS. As the Commission is aware, such a perception would be patently inaccurate. ORS selected its own expert witness and sponsored his testimony under oath in the evidentiary hearing in this case. ORS had ample notice of the deadline for filing its expert witness testimony in this case and ample opportunity to review the testimony of CWS's witness prior to

[4] Understandably, ORS fails to reference the Commission's rule on notice of cognizable facts and instead relies upon Rule 201(e) SCRE. Even assuming that Rule 201(e) SCRE could supplant the Commission's specific regulation in this regard, it does not compel any different result. Rule 201(e) SCRE requires that CWS be permitted an opportunity to be heard as to the propriety of the Commission taking notice of adjudicative facts. This has not been done given that ORS did not make any such request at hearing. To the extent that the Commission may intend to consider taking judicial notice as contemplated in ¶10 of ORS's proposed order, CWS hereby requests an opportunity to be heard in that regard as provided for by Rule 201 SCRE.

(Continued . . . .)

meeting that deadline. ORS had an opportunity to address any changes in the testimony of its expert witness at hearing and did not undertake to delete the two adjustments relied upon by Dr. Johnson that are now under attack by ORS. [Tr. p. 223, l. 20 - p. 225, l. 5.] For ORS to now present to the Commission a choice of accepting its revised version of Dr. Johnson's DCF opinion testimony or potentially be perceived as having increased the allowable ROE beyond that proposed by ORS not only disserves the process, but is inconsistent with "principles of fairness" that this Commission has been guided by in the past. *See* Order No. 2003-489, *supra*, at 9.

If you have any questions, or need additional information, please do not hesitate to contact me. By copy of this letter, I am making counsel for the other parties of record aware of these comments. With best regards, I remain

Respectfully,

WILLOUGHBY & HOEFER, P.A.

John M.S. Hoefer

JMSH/twb

cc: Florence P. Belser, Esquire
C. Lessie Hammonds, Esquire
Charles H. Cook, Esquire
Jessica J.O. King, Esquire